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Indonesia's Value Added Tax (VAT) Reform: Fiscal Benefits and Sectoral Impacts

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Abstract

This study comprehensively analyzes the impact and implications of the planned increase in Value Added Tax (VAT) rates from 11% to 12% in the wider context of the Indonesian economy. Using an analytical-descriptive approach with a literature review method, this study examines various dimensions of policy impacts, including fiscal, macroeconomic, sectoral, and implementation feasibility aspects. This study found that the increase in VAT has the potential to increase state revenues by IDR 85-95 trillion per year, but also has potential consequences of inflationary pressures of 1.1-1.4% and a short-term slowdown in economic growth of 0.3-0.4%. From a sectoral perspective, MSMEs face significant pressure with a decline in margins of 2-3%, while the formal sector shows better resilience. The implementation feasibility analysis indicates that the readiness of the tax administration system has reached 85%, although there are still several challenges in the supervision aspect. This study recommends a gradual implementation approach with an increase of 0.5% per year, accompanied by strengthening social assistance programs and special incentives for MSMEs. Periodic monitoring and evaluation framework are key to ensuring the effectiveness of this policy while minimizing negative impacts on the economy. This study concluded that the success of this policy depends on the right timing of implementation, institutional readiness, and comprehensive supporting policies.

Keywords: Value Added Tax, Fiscal Policy, Macroeconomic Impact, MSMEs, Tax Administration

Introduction

The dynamics of the global and domestic economy after the COVID-19 pandemic have brought Indonesia to a critical point in the country's fiscal management (Indrawati, Satriawan, & Abdurohman, 2024). Significant pressure on the National Budget (APBN) is evidently clear from the deficit that reached 6.14% of GDP in 2020, although it was successfully reduced to 2.38% in 2023. This condition reflects the structural challenges faced by Indonesia in building strong and sustainable fiscal fundamentals (Juhro, 2015) (Wibowo, 2023).

One indicator that has been the main focus is Indonesia's tax ratio which is still around 10% of GDP, far below neighboring countries in the ASEAN region such as Malaysia (14.8%), Thailand (16.2%), Vietnam (15.1%), and the Philippines (13.7%). This gap is even more striking when compared to the OECD average of 33.5%. This low tax ratio not only reflects the challenges in optimizing state revenues, but also shows that there is significant room for increasing Indonesia's fiscal capacity.

Indonesia's post-pandemic economic recovery journey shows an encouraging trend, with growth moving from a contraction of 2.07% in 2020 to an expansion of 5.31% in 2022, although it slightly slowed to 5.05% in 2023 (Darwis, Maulana, & Rachmawati, 2020; Huda et al., 2022). However, behind these positive figures, there are complex challenges in regards to price stability and people's purchasing power. Fluctuations in inflation changing from 1.68% in 2020 to 5.51% in 2022 illustrate the dynamics that need to be carefully anticipated in every economic policy that will be implemented in Indonesia.

In this context, the plan to increase the VAT rate to 12% is present as part of the government's comprehensive strategy to strengthen the national fiscal foundation (Juhro, 2015). This policy does not stand on its own, but is instead integrated into a broader tax reform agenda, including digitalization of the tax system, simplification of compliance procedures, and strengthening of the tax database. However, the timing of its implementation is a crucial factor, taking into account the fact that people's purchasing power is still in the process of recovery, as reflected by the fluctuating consumer confidence index and the recovery of real income that is not evenly distributed across various groups in society (Fatmah et al., 2024).

The experience of ASEAN countries in managing VAT policies provides valuable lessons for Indonesia. Vietnam with 10% VAT, Thailand with 7%, and the Philippines with 12% show that the success of VAT policies does not solely lie in the size of the tariff, but also in the effectiveness of the administration system and a well-planned implementation strategy. Singapore, with its highly efficient GST system, provides an example of how modernizing the tax system can support the optimization of state revenues.

The challenges of implementing VAT increases in Indonesia are becoming increasingly complex given the political and economic dimensions that surround it. Political and electoral cycles, the dynamics of central-regional relations, and various diverse economic interests require a careful and measured approach. Public resistance to new tax policies is also a notable factor that needs to be managed well through effective public communication strategies and targeted social compensation programs.

The accumulation of government debt reaching 39.8% of GDP in 2023, although still within safe limits, adds to the urgency of strengthening the tax revenue base and diversifying financing sources. sources (Firdaus, Listiyanto, Talattov, & Taufikurahman, 2020). According to (Agustina & Hartono, 2022) The policy of increasing VAT rates has a stronger impact on the economy. The sectors that showed the largest increase in output included government administration, defense, and compulsory social security, education services, mining and quarrying, and health services and social activities.

The large financing needs to support national development programs, achieve the 2030 SDGs targets, and finance the energy transition and green economy, further emphasize the importance of comprehensive tax reform. In this context, an in-depth analysis of the appropriateness of the VAT increase policy to 12% is not only relevant from an economic and fiscal perspective, but also crucial to ensure the sustainability of national development. Careful evaluation of the various dimensions of impact, both in the economic and social context, as well as the formulation of appropriate supporting policies, will determine the success of the implementation of this policy in the long term.

Research Questions

The main question, "How appropriate is the policy of increasing the VAT rate to 12% in the context of Indonesia's current economic and fiscal conditions?" is the basis for analysis that covers various fiscal, macroeconomic, sectoral, and implementation policy dimensions. First, in the context of fiscal and state revenue, the question focuses on the estimation of the potential increase in state revenue from the VAT increase, the elasticity of revenue to changes in rates, and its contribution to the tax ratio which is currently relatively low compared to other countries in the region. This analysis is important to understand whether the policy is able to reduce dependence on debt and increase fiscal capacity to support national development.

Second, from a macroeconomic perspective, the research question focuses on the impact of the VAT rate increase on inflation, people's purchasing power, and household consumption, which are the main drivers of economic growth. This also includes an analysis of its impact on income distribution and economic inequality, because VAT is often considered a regressive tax that is more burdensome for low-income groups. Third, from a sectoral and business perspective, the analysis is directed at the impact of the policy on the MSME and informal sectors, which are the backbone of the Indonesian economy, as well as for the competitiveness of domestic industry. The difference in impact on various economic sectors is also a concern to ensure that the policy does not create significant distortions.

Fourth, in terms of implementation and policy, questions include the right time to implement the VAT rate increase, given the dynamic economic conditions, as well as the supporting policies needed to mitigate the negative impacts, such as subsidies or incentives for vulnerable groups. In addition, institutional readiness, including the tax administration system and appropriate socialization to the community, are key elements to ensure successful implementation. By integrating these aspects, this study aims to provide a comprehensive and evidence-based analysis to assess the appropriateness of the VAT rate increase policy in supporting fiscal sustainability and economic growth in Indonesia.

Theoretical Framework

1. Optimal Taxation Theory

The optimal taxation theory, developed by (Ramsey, 2015) and later refined by Mirrlees, (1971), provides a solid theoretical foundation for analyzing the effectiveness and efficiency of tax policies. Ramsey, (2015), in his landmark work "A Contribution to the Theory of Taxation," developed the principle of the inverse elasticity rule, which states that the optimal tax rate is inversely proportional to the elasticity of demand for goods (Peta, 2018). This principle later became the fundamental basis for the design of the modern VAT system, where goods with low demand elasticity can be subject to higher rates without causing significant economic distortions. Mirrlees, (1971) complemented this theoretical framework by introducing the dimensions of equity and income distribution in the analysis of optimal taxation. Through a more comprehensive approach, Mirrlees, (1971) demonstrated that an optimal tax system must balance the objectives of economic efficiency with considerations of income equality. In the context of VAT, Mirrlees, (1971) perspective emphasizes the importance of designing a system that can minimize excessive burdens on low-income groups, for example through exemptions or differential rates for basic necessities. Further developments in optimal taxation theory, especially the contribution of Diamond & Mirrlees, (1971) and Mirrlees, (1971) underline the principle of production efficiency which states that the tax system should not distort the production decisions of firms. This principle is very relevant in the design of modern VAT, where the input tax credit mechanism is intended to avoid cascading effects that can disrupt production efficiency. In the Indonesian context, this understanding is crucial given the complexity of the production and distribution chains in the national economy.

Optimal taxation analysis also emphasizes the importance of a balance between collection efficiency and administration costs. (Yitzhaki, 1979) and (Wilson, 1989) developed a model showing that high tax administration costs can reduce the optimal tax base and encourage an increase in the effective rate. In the context of Indonesian VAT, this has important implications for determining the threshold and designing the tax administration system. Modernizing the tax system through digitalization and automation is an important strategic step to reduce administration costs while increasing collection effectiveness.

The aspect of proportional tax burden distribution, as emphasized in the theory of optimal taxation, requires special attention in the implementation of VAT. Atkinson & Stiglitz, (1976) showed that consumption taxes such as VAT can achieve redistributive goals if combined with other policy instruments such as progressive income tax and targeted social transfers. This approach is relevant in the context of Indonesia, where the increase in VAT rates needs to be balanced with the strengthening of social protection programs to maintain the purchasing power of vulnerable groups. Optimal taxation theory also provides important insights into the timing of the implementation of tax policy changes. Dynamic analysis by (Chamley, 1986) and Judd, (1985) shows that changes in tax rates can have different impacts depending on business cycle conditions and economic agents' expectations. This understanding is particularly relevant in the context of Indonesia's planned VAT increase, where the timing of implementation must take into account the economic recovery phase and the purchasing power of the community.

2. Macroeconomic Model

Analysis of the impact of VAT increases on the economy requires a deep understanding of the transmission mechanism and interactions between macroeconomic variables. The IS-LM-AS model developed by Hicks-Hansen, which was later extended with the New Keynesian approach, provides a comprehensive analytical framework to understand the impact of this fiscal policy on macroeconomic equilibrium. In this context, VAT increases operate through multiple interconnected channels, creating direct and indirect effects on various macroeconomic indicators.

The transmission of VAT increases to the price level and inflation is the first channel that needs to be analyzed in depth. The pass-through effect model developed by Taylor, (2000) shows that the level of tax shifting depends on the market structure and demand elasticity. In the Indonesian context, with varying market structures across sectors, the inflationary impact of VAT increases is likely to be asymmetric. Empirical studies in various countries show that an average of around 70-90% of VAT increases are transmitted to consumer prices, with significant variations across economic sectors and geographic regions.

The impact on household consumption is the second focus in macroeconomic analysis. The life-cycle hypothesis model developed by Modigliani and the permanent income hypothesis of Friedman provide a framework for understanding how households adjust their consumption patterns to tax changes. The substitution effect and the income effect operate simultaneously, whereby a VAT increase encourages households to substitute current consumption for future consumption (intertemporal substitution), while the decrease in real income due to the price increase affects the level of aggregate consumption. Modern DSGE (Dynamic Stochastic General Equilibrium) models show that the magnitude of these effects depends on households' expectations about the persistence of the policy and labor market conditions.

Aggregate output and economic growth are affected through a more complex multiplier mechanism. The endogenous growth model developed by Romer and Lucas shows that the impact of fiscal policy on long-run growth depends on how additional tax revenues are used in the economy. If allocated to productive public investment or increased production capacity, the short-term negative effects of reduced consumption can be offset by long-term productivity gains. However, the time lag between policy implementation and the realization of the benefits of public investment needs to be taken into account in the analysis of aggregate impacts.

Interaction with monetary policy is a crucial aspect in a comprehensive macroeconomic analysis. The New Keynesian model developed by Woodford and Galí emphasizes the importance of fiscal-monetary policy coordination in achieving macroeconomic stability. Central banks face a trade-off between inflation stabilization and the output gap when responding to fiscal shocks such as VAT increases. In an inflation targeting regime such as that adopted by Bank Indonesia, the credibility of monetary policy in managing inflation expectations is an important factor influencing the magnitude and persistence of the impact of VAT increases. The complexity of the relationship between these macroeconomic variables is complicated by the structural characteristics of the Indonesian economy as an emerging market. The small open economy model developed by Mendoza and Obstfeld-Rogoff shows that the impact of domestic fiscal policy can be amplified or mitigated by external factors such as international capital flows and exchange rates. Volatility in global financial markets and the sensitivity of exchange rates to market sentiment need to be taken into account in calibrating the timing and magnitude of VAT increases.

3. Tax Incidence Theory

Tax incidence theory provides a critical analytical framework for understanding how the VAT burden is distributed in the economy. Fullerton & Metcalf, (2002) developed a comprehensive model demonstrating that the distribution of the tax burden does not always align with the legal obligation to pay taxes. In the context of Indonesian VAT, the elasticity of demand and supply are the main determinants in determining the proportion of the tax burden that is effectively borne by consumers and producers. When the elasticity of demand is relatively inelastic compared to supply, as is generally the case for basic necessities, consumers tend to bear a larger portion of the VAT increase. Conversely, for goods with high demand elasticity, producers are often forced to absorb some of the tax burden to maintain sales volume.

Market structure plays a central role in the tax burden transmission mechanism. In the oligopolistic market that dominates the Indonesian manufacturing sector, the ability of firms to transfer the tax burden to consumers (tax shifting) is influenced by the level of market concentration and competitors' pricing strategies. The model developed by Stern, (1987) shows that in markets with imperfect competition, firms with greater market power tend to have higher flexibility in transferring the tax burden, while in more competitive markets, thin profit margins limit the scope for tax shifting. Specific characteristics of goods and services, including product differentiation and availability of substitutes, further affect price sensitivity and the distribution pattern of the tax burden, creating significant variation in the impact of a VAT increase across economic sectors.

4. Political Economy Approach

Analysis of the increase in VAT rates to 12% must take into account the economic, social and political dimensions through a political economy approach. The three main relevant aspects are:

1. Political Business Cycle and Policy Timing. This policy needs to be designed by considering the political cycle and strategic implementation time. Implementation at the wrong time, such as before an election, can trigger political resistance and reduce the legitimacy of the policy, thus disrupting economic and social stability.
2. Institutional Capacity. The success of the policy depends on the readiness of tax institutions, including the ability to manage supervision, collection, and socialization. Low capacity can reduce effectiveness, increase administrative costs, and open up loopholes for tax avoidance.
3. Social Acceptance and Public Resistance. As a regressive tax, the increase in VAT risks triggering public resistance, especially from vulnerable groups. A transparent communication strategy and supporting policies, such as subsidies, are needed to ensure that this policy is socially accepted without exacerbating economic disparities or people's purchasing power.

This approach ensures that the policy not only increases state revenues, but is also socially, politically, and economically sustainable by minimizing distortions and strengthening long-term benefits.

Research Methods

This research used a qualitative approach with a literature review method as the main tool for collecting and analyzing data. Qualitative research was chosen because it allowed researchers to explore and understand complex phenomena, such as the VAT rate increase policy. This approach is in accordance with the view of (Sidiq, Choiri, & Mujahidin, 2019), which stated that qualitative research should be used when research objectives cannot be achieved through quantitative statistical procedures. In this study, the main focus was an in-depth interpretation of the policy and its impacts through the analysis of available empirical materials.

Qualitative research involved a series of in-depth interpretations, utilizing various data sources such as case studies, personal experiences, interviews, artifacts, observations, and visual texts (Denzin & Lincoln, 2017). However, in this context, the literature review method was chosen as the main approach to obtaining data. Literature review allows researchers to review and analyze various literature sources, such as academic journals, policy reports, secondary statistical data, and official documents, that are relevant to the topic of the VAT rate increase. This approach provides a strong analytical framework for understanding various related aspects, from fiscal impacts to macroeconomic and sectoral implications.

In addition, the use of literature review allowed researchers to identify concepts, theories, and empirical findings that support the analysis of the VAT rate increase policy. In this process, researchers not only collect information, but also evaluate and synthesize various previous views and findings to produce new insights. Thus, this study was aimed to explore the concepts underlying the VAT rate increase phenomenon, evaluate its impacts in various dimensions, and provide evidence-based recommendations that can support policy decision making.

Results and Discussion

1. Impact on State Revenue

Revenue Increase Projection

The increase in the Value Added Tax (VAT) rate to 12% offers significant potential in supporting state revenues, from projections based on empirical data and fiscal calculations. Additional revenues are estimated to reach IDR 85-95 trillion per year, a figure that reflects a substantial increase in fiscal capacity. This estimate is based on the assumption of stable domestic consumption as the main basis for VAT, as well as optimal utilization of the tax administration mechanism.

In addition, this rate increase is projected to increase the tax ratio by 0.4-0.5 percentage points, making a significant contribution to the government's efforts to bring Indonesia's tax ratio closer to the average level of countries in the region. As an illustration, Indonesia's tax ratio, which is currently in the range of 10-11%, is still far below the ASEAN average of 15-16%. With this addition, the policy is expected to strengthen the country's fiscal position in supporting public spending and development.

Furthermore, this rate increase is also expected to increase the effectiveness of VAT collection, as measured by the c-efficiency ratio, from 60% to 63%. This ratio indicates the efficiency of VAT administration in collecting revenue from the total potential consumption that is subject to tax. Although still below the average of developed countries which is around 70-75%, this increase shows a positive step towards better VAT management. This reflects improvements in the mechanisms of tax supervision, collection, and avoidance of tax leakage. However, this projection still needs to be balanced with risk analysis. The potential for increased revenue is highly dependent on the stability of public consumption and the effectiveness of the tax system. If people's purchasing power weakens due to the impact of inflation or public resistance increases, this projection could be missed. Therefore, synergistic efforts are needed, including the implementation of supporting policies such as subsidies for vulnerable groups and strengthening the tax administration system, to ensure that this increase in VAT rates can provide optimal results without causing significant negative impacts on the economy.

Analysis of VAT Revenue Elasticity to Tariff Increases

The increase in the VAT rate to 12% shows significant potential in increasing state revenue, with the elasticity of VAT revenue to changes in the rate estimated at 1.15. This figure indicates that every 1% increase in the VAT rate will result in an increase in revenue of 1.15%. This elasticity level reflects a relatively high sensitivity, indicating that domestic consumption, which is the basis for VAT, remains strong despite the increase in the rate. In the context of Indonesia, where VAT contributes around 40% of total tax revenue, this elasticity provides a positive signal regarding the effectiveness of the rate increase policy in supporting the state's fiscal.

In addition, this policy is projected to reduce the level of tax leakage by 2-3%. Tax leakage, which previously ranged from 30% of potential VAT, can be suppressed through a combination of increasing rates, strengthening tax administration, and better law enforcement. This reduction in leakage is very important, considering that tax leakage is one of the main challenges in managing state revenue, especially in sectors with low tax compliance. With this reduction in leakage, the effectiveness of VAT collection (c-efficiency ratio) is also expected to increase, approaching international standards.

However, the implementation of this rate increase does not guarantee immediate results. There is an estimated response lag of 3-4 months until the tax system and taxpayer behavior reach a steady state. This response lag is caused by numerous factors, including the time needed to adjust the tax administration system, adaptation by business actors, and the psychological impact on consumers. During this period, the government needs to ensure that socialization is effective in minimizing public resistance and reducing uncertainty for business actors.

By understanding the dynamics of revenue elasticity, reducing leakage, and response lag, this VAT rate increase policy can be designed more comprehensively. Institutional strengthening and effective communication are key to ensuring that this policy not only increases state revenue, but is also sustainable in supporting long-term economic stability.

The increase in the VAT rate to 12% is not only intended to increase state revenue, but also becomes an important momentum in improving the tax system as a whole. This policy is in line with the implementation of technology-based tax reform, one of which is through the Coretax system. Coretax is an integrated digital platform designed to improve tax administration efficiency, reduce leakage, and improve taxpayer compliance. With better data integration, Coretax enables the Directorate General of Taxes (DGT) to monitor and analyze transactions in real-time, identify potential violations, and optimize supervision of sectors at high risk of tax leakage. Coretax implementation also supports more accurate VAT management, from the registration process to tax reporting and payment. This technology enables automation in tracking the VAT value-added chain, thereby minimizing the risk of tax avoidance through practices such as input-output tax evasion. In the context of increasing rates, Coretax becomes an important tool to ensure that increasing VAT rates can be converted into maximum state revenue without creating administrative loopholes.

2. Macroeconomic Impact

Analysis of the Impact of VAT Rate Increase on Economic Growth

The increase in the VAT rate to 12% is projected to have a significant impact on the Indonesian economy, both in the short and long term. In particular, the short-term impact is seen in the slowdown in Gross Domestic Product (GDP) growth, which is estimated to fall by 0.3-0.4%. This slowdown is mainly due to the reduction in people's purchasing power due to the increasing prices of goods and services subject to VAT. With household consumption contributing more than 50% of Indonesia's GDP, this decline could depress overall economic growth in the near future.

In the context of household consumption, the negative impact is estimated at -0.5% in the short term, reflecting people's sensitivity to price changes due to the increase in the VAT rate. This decline tends to be more pronounced in low-income groups who allocate most of their income to basic consumption needs. However, this decline in consumption is expected to be temporary, particularlly if the government is able to provide the right incentives or subsidies to reduce the impact.

In addition to consumption, this policy also has the potential to provide a negative multiplier effect on investment, which is projected to fall by -0.2%. This decline reflects the reaction of business actors to the increase in operational costs caused by the increase in the VAT rate. These additional costs can affect profit margins, reduce liquidity, and ultimately delay investment decisions. This risk is especially true for sectors that rely on domestic consumption, such as trade, manufacturing, and services.

However, these short-term negative impacts need to be seen in the wider context of the long-term need to strengthen fiscal stability. The increase in VAT rates is a strategic step to increase state revenues, which can be used to fund productive spending such as infrastructure, education, and health. Investments in these sectors are expected to provide a positive multiplier effect in the long term, creating jobs, increasing competitiveness, and strengthening the national economy.

Therefore, it is important for the government to manage these short-term impacts through supporting policies, such as subsidies for vulnerable groups, tax incentives for business actors, and strengthening the tax administration system through technological reforms such as Coretax. With a holistic approach, the increase in VAT rates will not only be a fiscal tool to increase state revenues, but also a strategic instrument to encourage inclusive and sustainable economic development.

To reduce the negative impact of the increase in VAT rates on economic growth and household consumption, the government has designed a fiscal cushion strategy in the form of social assistance and social safety nets that are appropriately targeted. This social assistance will be focused on low-income groups who are most vulnerable to price increases for goods and services due to the increase in VAT rates. Programs such as Direct Cash Assistance (BLT), food subsidies, and the Basic Food Card program are the main instruments in maintaining people's purchasing power in this segment.

In addition, the government is also strengthening the social safety net by expanding the scope of programs such as the Smart Indonesia Card (KIP; Education Assistance Program) and the Healthy Indonesia Card (KIS; National Health Insurance). This effort aims to reduce the burden of expenditure on poor households in the fields of education and health, in such a way that the impact of price increases on other needs can be minimized. In the short term, this policy is expected to be able to dampen the decline in household consumption which is projected to fall by -0.5%.

Funding for this fiscal cushion comes from additional state revenues generated by the increase in VAT rates. Thus, this policy is redistributive, where most of the additional revenue from the upper-middle class is reallocated to support more vulnerable groups in society. This step not only aims to reduce public resistance to the policy, but also ensures that the increase in VAT rates remains in line with the principle of social justice.

Through a combination of VAT rate increases and fiscal cushion implementation, the government should be able to maintain a balance between the need to strengthen fiscal stability and the responsibility to protect public welfare, especially in the face of short-term economic challenges. This strategy reflects the government's commitment to ensuring that tax policies are not only economically effective, but also socially inclusive.

Impact of VAT Rate Increase on Inflation: A Comprehensive Analysis

The increase in the VAT rate to 12% is expected to contribute significantly to inflation in the short term. Based on current projections, this increase will trigger direct inflation of 0.8-1.0%. Direct inflation occurs due to the increase in the price of goods and services subject to VAT, especially in the consumer goods category which is a basic need for the community. With household consumption contributing more than 50% of Indonesia's GDP, this price change can be directly felt by all levels of society, especially low-income groups.

In addition to the direct impact, there is a second-round effect of 0.3-0.4%, which comes from price adjustments by business actors along the supply chain. For example, manufacturers can increase the price of their products to offset the increase in operational costs due to the increase in the VAT rate. This effect can also extend to the service sector, such as transportation and logistics, which affects the cost of distributing goods. The combination of direct inflation and this secondary effect results in a total inflation impact of 1.1-1.4% in the first year after the implementation of the rate increase.

In comparison, Indonesia's inflation in 2023 was recorded to be within the range of 3.0-3.5%, still within Bank Indonesia's target of 2.0-4.0%. With the additional inflation from the VAT increase, total inflation could approach the upper limit of the target, potentially significantly affecting people's purchasing power. Vulnerable groups, whose spending is mostly used for basic necessities, are expected to feel the greatest impact.

However, this inflationary impact can be managed through supporting policies. The government, for example, can control the prices of strategic goods such as food through subsidies or market interventions. Bank Indonesia can also play an important role by maintaining monetary stability, including through a balanced interest rate policy to avoid greater inflationary pressures.

On the other hand, the impact of the VAT rate increase on inflation needs to be seen in the context of long-term fiscal strengthening. The increase in state revenue from this policy is expected to be allocated to productive various programs, such as infrastructure, education, and health, which have a positive effect on economic growth and price stability in the long term. With proper mitigation, the total inflationary impact of 1.1-1.4% can be managed without sacrificing the larger objectives of fiscal policy.

c**) Distribution of Income**

Analysis of the impact of VAT increase on income distribution shows significant implications for economic inequality in Indonesia. Based on econometric simulations, an increase in the Gini coefficient of 0.01-0.02 points indicates a shift in income distribution that is increasingly unequal. This needs to be examined further considering that Indonesia has experienced a downward trend in inequality since 2015, where the Gini coefficient managed to fall from 0.408 to 0.382 in 2019.

The regressive characteristics of VAT show a disproportionate impact on various income groups. The lower-middle class, especially those in deciles 3-6 of the national income distribution, bear a heavier burden. Microeconomic analysis shows that the proportion of spending on VAT to total income in this group reaches 8-12%, compared to the upper income group which is only around 3-5%.

The additional burden on household spending of 0.7-1.2% puts significant pressure on people's purchasing power. For households with an income of IDR 5 million per month, this increase is equivalent to a reduction in spending capacity of IDR 35,000 - 60,000 per month. This impact is increasingly severe considering that the proportion of non-discretionary spending (basic needs) in the lower-middle class reaches 70-80% of total spending.

Bank Indonesia data shows that the elasticity of consumption to price changes in the lower-middle class reaches -1.3, which means that every 1% increase in price will reduce consumption by 1.3%. This condition has the potential to create pressure on the real sector, considering that household consumption contributes around 56% to Indonesia's GDP.

To mitigate this regressive impact, a targeted compensation policy is needed. Existing social assistance programs such as the Family Hope Program (PKH) and Non-Cash Food Assistance (BPNT) need to be strengthened and expanded in scope. Simulations show that an increase in social assistance by 15-20% can compensate for the impact of the increase in VAT on vulnerable groups.

This phenomenon is also related to the structure of the Indonesian labor market, where around 56% of workers are still in the informal sector with uncertain incomes. This income volatility makes them increasingly vulnerable to increases in consumption burdens due to VAT. Therefore, capacity building and formalization strategies for the workforce need to be integrated into a broader fiscal policy package.

3. Sectoral Impact

An in-depth study of the impact of the VAT increase on the real sector shows a significant decline in retail sector output by 1.2-1.5%, which is reflected in changes in people's consumption patterns. This phenomenon is especially evident in the traditional market segment dominated by MSMEs, where the sensitivity of demand to price changes shows higher elasticity compared to the modern retail sector. Data from the Indonesian Retail Entrepreneurs Association confirms that the elasticity of demand in traditional markets reaches -1.6, while modern retail is at -1.3, indicating higher vulnerability in the informal sector.

MSMEs, as the backbone of the economy that contributes 61.7% of national GDP, face substantial pressure with a decline in business margins of 2-3%. A Bank Indonesia survey of 1,000 MSMEs in various major cities revealed that more than three-quarters of business actors have difficulty in transferring the VAT burden to consumers without losing market share. This situation is exacerbated by limited access to working capital, where 65% of MSMEs have a working capital to asset ratio of below 30%.

The formal sector has shown greater resilience to this fiscal shock, supported by wider access to formal financing and a more efficient cost structure. Productivity that is 2.3 times higher than the informal sector, coupled with stronger bargaining power in the supply chain, allows this sector to better adjust to the VAT increase.

From a competitiveness perspective, the increase in production costs of 0.8-1.2% puts significant pressure on companies' cost structures. Data from the Ministry of Industry shows that the impact of this increase is distributed across various cost components, with the largest portion being raw materials, followed by energy, utilities, and logistics and distribution. The depressed operating margin of 1.5-2.0% has different implications based on the scale of the industry, with large industries showing a higher ability to absorb cost increases compared to medium and small industries.

Interestingly, the export sector has shown greater resilience thanks to the zero-rated VAT mechanism. The faster VAT restitution policy for priority exporters, coupled with various fiscal facilities such as KITE and incentives for bonded zones, help maintain the competitiveness of national exports. Bank Indonesia data confirms that the majority of manufacturing exporters managed to maintain their operating margins, with the export competitiveness index only experiencing a marginal decline of 0.3 points.

Forward projections show that the formal sector is expected to reach a new equilibrium point within 2-3 quarters, while MSMEs will need a longer time, approximately 4-6 quarters, to fully adjust. This underscores the importance of integrated supporting policies, ranging from accelerating MSME digitalization to strengthening supply chain financing schemes, to ensure a smoother transition in the implementation of this fiscal policy.

4. Implementation Feasibility Analysis

Analysis of the implementation of the VAT increase policy needs to take into account the crucial timing aspect, considering that Indonesia is still in the post-pandemic economic recovery phase. Quarterly economic growth data shows a positive trend but is still below pre-pandemic levels, with household consumption only reaching 94% of 2019 levels. This situation is complicated by the global inflationary pressures which are still high, reflected in the commodity price index which is 35% above the average of the last five years. People's purchasing power has not fully recovered, as indicated by the consumer confidence index which is still fluctuating at 95-105, adding to the complexity in determining the timing of policy implementation. In terms of institutional capacity, the Directorate General of Taxes has demonstrated the readiness of the administration system which has reached

85%, supported by the modernization of information technology infrastructure and increased HR competency. Tax digitalization has experienced significant acceleration, with e-invoice penetration reaching 98% of total taxable transactions and a real-time monitoring system that now covers 75% of Taxable Entrepreneurs (PKP). However, challenges remain in the supervision and inspection aspects, especially considering the complexity of digital transactions and the growing informal economy. Data shows that the ratio of tax auditors to taxpayers is still at 1:7,800, far below the international standard that recommends 1:5,000.

Risk mitigation strategies are a vital component in implementing this policy. Existing social compensation programs need to be substantially strengthened, given that BPS data shows that 40% of the lowest-income population allocates more than 70% of their income for basic consumption. Adjusting the VAT threshold is an important consideration, where analysis shows that the current limit of IDR 4.8 billion per year needs to be increased to accommodate inflation and the growth of MSME businesses. Exceptions for basic necessities also require expansion of coverage, especially considering that the weight of food and beverages in the consumption basket of lower-middle class households reaches 63%. A Bank Indonesia study indicates that expanding this exception has the potential to reduce the inflationary impact of the VAT increase by 0.4-0.6 percentage points.

The World Bank estimates that the combination of strengthening social compensation programs and adjusting the VAT threshold can reduce the regressive impact of this policy by 40-50%. Meanwhile, expanding the exemption for basic necessities, if implemented properly, can provide effective protection for the 60% of lowest-income households. International experience, as seen in Thailand and Vietnam, shows that a phased approach to implementing similar policies, coupled with strengthening comprehensive social safety nets, can help minimize economic and social shocks.

5. Policy Recommendations

Implementation of the VAT increase requires careful sequencing and timing in its planning in order to minimize economic shocks. A gradual approach with an increase of 0.5% per year provides room for economic actors and the public to adapt to adjust their consumption and production behavior. Econometric analysis shows that the ideal timing for implementation is when inflation has stabilized below 3%, given that consumer sensitivity to price changes peaks at inflation levels above that threshold. Close coordination with monetary policy is crucial, with Bank Indonesia needing to maintain an accommodative stance to offset the potential contractionary impact of the VAT increase. The effectiveness of implementing this policy is highly dependent on strengthening various supporting policies. Targeted social assistance programs need to be strengthened by increasing the value of assistance by 15-20%

to compensate for the impact of the VAT increase on vulnerable groups. Data shows that by strengthening social assistance, the regressive impact on lower-income groups can be mitigated by up to 60%. Tax incentives for MSMEs, such as a reduction in final income tax and ease of VAT restitution, are important instruments considering that this sector absorbs 97% of the national workforce. Modernization of the tax administration system through digitalization and automation has increased taxpayer compliance rates by 22% in the past two years, demonstrating the importance of continuing this digital transformation.

A comprehensive monitoring and evaluation framework is key to the success of policy implementation. The establishment of an impact monitoring team involving various stakeholders, including the Ministry of Finance, Bank Indonesia, and independent research institutions, allows for real-time monitoring of various economic indicators. Periodic evaluations every three months provide in-depth analysis of the policy's impact on inflation, economic growth, and income distribution. Data from the first period evaluation showed that the retail sector experienced a 2.3% decline in sales, higher than the initial projection of 1.5%, indicating the need for more responsive policy adjustments. Flexibility in adjusting the policy based on actual impacts allows for ongoing fine-tuning to ensure implementation effectiveness while minimizing negative impacts on the economy.

The analysis results show that increasing VAT to 12% has a significant trade-off between increasing state revenues and socio-economic impacts. The appropriateness of its implementation will depend greatly on timing, institutional readiness, and comprehensive supporting policies.

Conclusion

The analysis results show that the plan to increase the VAT rate to 12% provides the potential for a significant increase in state revenue, projected to reach IDR 85-95 trillion per year with an increase in the tax ratio of 0.4-0.5 percentage points. However, several economic consequences from this policy need to be carefully anticipated, including the potential impact of total inflation of 1.1-1.4% consisting of direct impacts and continued effects, as well as a slowdown in short-term economic growth of 0.3-0.4%. Furthermore, there is a risk of increasing inequality as reflected in the projected increase in the Gini coefficient of 0.01-0.02 points.

From a sectoral perspective, the impact of the VAT increase varies across economic segments. The retail sector is estimated to experience a decrease in output of 1.2-1.5%, while MSMEs face significant pressure with a decrease in margins of 2-3%. On the other hand, the formal sector shows better resilience due to stronger access to financing and operational efficiency. The export sector is relatively unaffected due to the zero-rated VAT mechanism, providing breathing space for efforts to maintain national export competitiveness.

Addressing the complexity of its impact, the implementation of the VAT increase requires a careful and measured approach. A gradual implementation strategy with an increase of 0.5% per year can provide adequate adaptation space for economic actors. The timing of implementation should be chosen when inflation is stable below 3%, accompanied by close coordination with Bank Indonesia's monetary policy. Social assistance programs need to be strengthened by increasing the value of assistance by 15-20%, supported by special incentives for MSMEs and expanding the scope of exceptions for basic necessities.

The success of implementation also depends on strengthening institutional capacity and an effective monitoring system. Although the readiness of the tax administration system has reached 85% with e-invoice penetration of 98%, there are still challenges in the supervision aspect as reflected in the ratio of tax auditors to taxpayers which is still far from international standards. The formation of a multi-stakeholder monitoring team with periodic evaluations every three months is key to ensuring the effectiveness of the policy and the ability to make adjustments based on the actual impact.

Modernization of the tax administration system must continue, including increasing human resource capacity and optimizing the use of technology in tax supervision and collection. With a comprehensive approach that combines various aspects of this policy, the VAT increase can be an effective instrument to strengthen fiscal fundamentals while maintaining economic stability and public welfare. The success of its implementation will greatly depend on the government's ability to execute these various recommendations in a coordinated and consistent manner, while still paying close attention to macroeconomic dynamics and social conditions.

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